Office of Chief Counsel
Internal Revenue Service

memorandum

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MFODonnell

date: OCT 15 1999

to: Ronald Calewarts, Foreign Joint Venture Specialist

from: District Counsel, Midwest District, Milwaukee

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subject: Filing of Substitute for Returns on Failure to Withhold on Payments of Interest to a Foreign Entity

Issue:

You asked for advice with respect to how to proceed when faced with a U.S. partnership's failure to withhold on payments of interest to its foreign partners, where the partners fail to file 1120Fs and pay tax with respect to the income.

Facts:

The facts, as we understand them, are as follows: a U.S. partnership (Partnership) is formed as a financing vehicle for two Canadian corporate partners. Partnership borrows money from its partners and lends it to entities related to the partners. Partnership pays interest to its partners for the use of this money. For purposes of this memorandum. we are to ignore the implications of conduit financing inherent in this arrangement. As fixed or determinable annual or periodic income from U.S. sources, the interest is subject to a 30 percent tax rate, or lower treaty rate. In this case, a lower rate applies, in accordance with the 1995 protocol to the U.S.-Canada treaty, by which interest paid to a resident of the other Contracting State is subject to a maximum withholding tax of 10 percent, effective for interest paid or credited on or after January 1, 1996.

Partnership does not withhold on these payments, however, in violation with the 1995 protocol. The Canadian partners do not pay U.S. tax on the interest income, nor do they file 1120Fs with respect to the income.

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Analysis:

In general, section 881 of the Code imposes a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income ("FDAP"), to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

Section 1442 provides that, in the case of foreign corporations, there shall be deducted and withheld at the source a tax equal to 30 percent in the same manner and on the same items of income as is provided in section 1441. Section 1441 states, in part, that all persons, in whatever capacity acting, having control, receipt, custody, disposal, or payment of any items of income specified in section 871 of any nonresident alien individual or of any foreign partnership shall deduct and withhold from such items a tax equal to 30 percent thereof. As stated, the operative U.S.-Canada protocol reduces the rate of withholding to 10 percent.

The Canadian partners have U.S. assets that may serve as a source for collection of the substantive liability. You therefore asked whether the U.S. tax due on the interest may be collected directly from the Canadian partners, by filing substitute for return 1120Fs. You also asked whether we may file a substitute for return 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and collect the 10 percent that should have been withheld by Partnership. Finally, you asked whether the withholding tax liability is a TEFRA item.

We believe that in both cases, substitute for returns may be filed against either or both the Partnership, or the Canadian partners. Section 6020 authorizes the IRS to make a return for any tax under title 26 for the taxpayer from its own knowledge and information where no return has been filed. Every U.S. withholding agent who controls, has custody of, disposes of, or pays fixed or determinable periodic income must annually file with the IRS returns on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. Treas. Regs. § 1.1461-1(b)(1) and (c)(1). A penalty may be imposed for not filing Form 1042 when due. See FSA 1998-220 (January 1, 1992). The penalty is equal to 5 percent of the unpaid tax for each month or part of a month the return is late up to a maximum of 25 percent of the unpaid tax. I.R.C. § 6651(a)(1).

As no return was filed by the partnership (1042) or the partners (1120F), the statute of limitations would not have expired with respect to either the substantive liability of the partners or the withholding liability of the partnership. I.R.C. § 6501(c)(3). Furthermore, the filing of substitute for returns would not begin the running of the statute of limitations for assessment of the taxes. I.R.C. § 6501(b)(3).

You also asked where the partnership's requirement to file Form 1042 on the interest payments, and its liability for failure to do so, is a "partnership item" under section 6231. We believe that it is.

The tax treatment of partnership items is determined at the partnership level. I.R.C. section 6221. Thus, if the items at issue are partnership items, then the adjustment must be made through a TEFRA proceeding. I.R.C. § 6221. The partnership's aggregate income, gain, loss, and deductions, and each partner's share thereof, are expressly defined by the regulations as partnership items. Treas. Regs. § 301.6231(a)(3)-1(a)(1)(i). We have previously concluded that the section 1446 withholding tax, dealing with effectively connected taxable income allocable to a foreign partner, is a provision of subtitle A required to be taken into account for the partnership's taxable year and more appropriately determined at the partnership level than at the partner level. Examinations with respect to section 1446 are therefore subject to the uniform partnership audit proceedings prescribed by sections 6221-6233. FSA 1998-314 (May 7, 1993); I.R.C. § 1461. We believe that the same reasoning applies to the 1442 withholding tax.

We note that in this same field service advice memorandum, the national office advised that there is a possibility that a court might conclude that the withholding tax liability is not a partnership item, but rather an affected item. This is because the tax itself is not a flowthrough item in the same sense as most partnership items of income and loss. See FSA 1998-314, supra. Subsequently, upon resolution of the issues raised in the FPAA, an affected items notice of deficiency should be issued to the partnership.

Please call me at (414) 297-4235 if you have any questions or comments with respect to this advice.

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